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## The Three Amigos – Henry, Ripoll and Cooper – what they mean for the Australian wealth industry

Now that the dust has started to settle after the publication of the Henry Review and the Government's initial response, it's time to stake stock and look at the whole picture and its implications for the wealth management industry.

Last year we described Henry, Ripoll and Cooper as having the potential to play three horsemen of the apocalypse. Frankly so far it's more like The Three Amigos. We have a government that likes starting reviews, but is less confident dealing with the outcomes. That's not necessarily a criticism. While there has been much berating of the Government's cautious response to the Henry recommendations in particular, on the principle of "first do no harm", caution is entirely in order.

For all its shortcomings, Australia's compulsory defined contribution system of superannuation is a national treasure. Seriously. I'll take volatility any day over the technically insolvent defined benefit schemes of the northern hemisphere. And the GFC demonstrated the value of having a deep local pool of long term equity capital which could be – and was – rapidly deployed to recapitalise Australian companies.

This is not something you want to mess with too much, plus it's perfectly reasonable for Australians to demand some certainty and continuity in how the system will treat them.

### Henry: Good outcomes, bullets dodged

The gradual increase in minimum super contributions to 12% and the effective refund in contributions tax for lower income earners means that the foundations of super have been materially strengthened.

While most comment has focused on the good news for wealth, some Henry bullets were dodged – at least for now.

- A recommended increase in tax on super contributions from a flat 15%, to marginal rates less a rebate, was not accepted.
- Also not accepted was a proposed reduction in the tax discount on long term capital gains, and a 40% reduction in the deductible interest expense of geared investments such as listed shares.
- Lobbying for compulsory annuities on retirement, or the public provision of annuities, fortunately made no headway.
- The Government even appears to have learnt from recent mistakes in super, easing the contribution cap reductions for those approaching retirement.

**Think the response to Henry was too timid?  
Be careful what you wish for:**

<b>Super contributions taxed at marginal rates less a rebate</b>	Recommendation not accepted
<b>40% cut in interest deductibility on gearing strategies</b>	Recommendation not accepted
<b>Compulsory annuities</b>	Not recommended

However this is not the end of the matter, even if the Government can get its immediate agenda including the resources super-tax passed. You can be sure that lobbyists for recommendations which did not get up, will be back.

**Henry and friends**

So does the Government's approach to Henry make sense in the light of the other reviews? Do we have joined-up policy?

In the case of Ripoll, more or less yes. The Government probably thought it politically necessary to do something about commissions before it injected more assets into the system.

The unbundling of product and advice costs is a global trend; Australia is more or less tracking the reforms proposed in the UK's Retail Distribution Review. Even the timing is the same, with both Australia and the UK working to a 2012 schedule.

That's not to say the Government's Future of Financial Advice Reforms are perfect. In our view they go too far; in particular the ban on advice fees in relation to geared up investment capital is unnecessary.

If the issue is inappropriate recommendations regarding gearing, the new fiduciary duty of financial planners should take care of this. Under such a duty, planners are likely to be cautious in recommending gearing, and where it is appropriate they should be properly remunerated for developing the strategy.

Cooper, on the other hand, is the odd review out. Let's face it, Cooper hasn't delivered much so far, apart from some nice SMSF statistics:

- The commission proposals were overtaken by the Future of Financial Advice Reforms.

- The e-administration recommendations are motherhood – hard to object to - but clearing houses were already moving in this direction.
- The MySuper default option proposals are baffling. Simple defaults exist already. They're called industry funds, and they have driven down the price of defaults across the industry.
- Cooper has also fallen into the trap of "too much choice must be a bad thing", a bit like arguing that having dozens of cereal brands in supermarkets must be inefficient. Put behavioural finance theory to one side: it is choice of, and within super that puts competitive pressure on trustees to keep improving defaults.

You can make an argument that defaults have become over-engineered, and that scope creep is evident in marketing such as sponsoring sports teams. But the best answer would be exposing funds to more competition, not more regulation.

As we noted in the last Dimensions, if you were serious about improving efficiency, you would do something about small SMSFs. But Cooper ducks this on the rationale that it represents active member choice, so it doesn't really matter. But this is just wrong, because SMSFs receive tax concessions too. Taxpayers have a legitimate interest in seeing tax concessions not wasted on small funds with astronomic cost ratios.

**Henry + Ripoll + Cooper = ?**

Notwithstanding that Cooper's final report is not due until June 30, the message from the Government to the industry is generally positive.

Indeed there's plenty of good news. In taking a cautious approach, the Government avoided damaging the system, and the market growth rate will tick up. Having declined to enter the retirement income market by providing public annuities, the Government has passed to the industry the challenge of innovating robust retirement income solutions that effectively address investment and longevity risk.

The bad news, if you can call it that, is that the wealth industry's "MER" needs to come down over time, and

demonstrably so if the Government's confidence is to be retained.

This will be partly achieved by the unbundling of product and advice costs and new models of financial planner remuneration. But it's not just about retail prices coming down. It's about controlling costs within SMSFs, and also within industry funds.

Naturally, what comes out the other end of the political sausage machine doesn't always look like the original proposals. But with that caveat, we can expect significant changes in the industry:

- Super remains the cornerstone of an industry that will be in a stronger position. But it will need new retirement income solutions, and investment and business models that will bring the overall industry MER down.
- There will be more consolidation. Retail has substantially consolidated already, and it is generally accepted that industry funds must further consolidate too, or at least find ways to pool resources more effectively. It also seems likely that there will be consolidation of SMSF administration, currently a cottage industry.
- While super remains at the heart of most investors' strategy, increasingly it will not be enough. Reduced contribution caps mean that many people need a third plank beyond home

and super – which is likely to be geared growth assets. Despite the advice remuneration issues around gearing, we expect to see increased use of gearing strategies.

- The movement of financial planning businesses into product manufacturing, already underway, will accelerate. Even if commission structures can be swapped for comparable asset fee arrangements, there will be advantages to having an ownership interest in product revenues.
- The unbundling of product and advice has the potential to shake up the dominance of traditional investment platforms and managed investments amongst financial planners, in favour of software which can replicate the benefits of platforms, and direct investments such as ETFs.
- Finally, there could be a bigger direct channel as the cost of advice becomes more visible and annual fees have to be renewed. Given the complexity of super, tax and social security, quality advice is under no threat, although it might be less lucrative than it has been in the past. But overall, the advice part of the value chain is going to be squeezed for the first time.

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